

**Letter of Findings Number: 04-20100463**  
**Use Tax**  
**For Tax Years 2007-09**

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**ISSUE**

**I. Use Tax—Imposition.**

**Authority:** General Motors Corp. v. Indiana Dep't of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991); North Cent. Industries, Inc. v. Indiana Dep't of State Revenue, 790 N.E.2d 198 (Ind. Tax Ct. 2003); IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-1-1; IC § 6-8.1-5-1; IC § 6-2.5-5-3; [45 IAC 2.2-3-4](#); [45 IAC 2.2-1-1](#).

Taxpayer protests the imposition of use tax on certain purchases it believes are exempt from use tax.

**STATEMENT OF FACTS**

Taxpayer is an Indiana S corporation. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer had purchased some items of tangible personal property in retail transactions, but had not paid sales tax on those purchases. The Department therefore issued proposed assessments for use tax and interest on those purchases. Taxpayer protested a portion of those proposed assessments. In the course of the protest process, Taxpayer provided documentation supporting its position that some of the items under protest were not subject to use tax. Taxpayer also had a question regarding certain recent payments made by Taxpayer's owner and what impact those payments would have on the liabilities at issue in this protest. After receiving documentation on the liabilities which were paid, the Department was able to determine that those liabilities were for the owner's individual income tax liabilities. Those payments therefore have no effect on the liabilities at issue in this use tax protest. Regarding the remaining use tax items, an administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

**I. Use Tax—Imposition.**

**DISCUSSION**

Taxpayer protests the imposition of use tax on some items which the Department had determined were subject to use tax. Specifically, Taxpayer protests the inclusion of its purchases of gift baskets which it sent to its customers, the inclusion of labor charges listed on one invoice, and the inclusion of the purchases of a drill sharpener and parts for that drill sharpener. Taxpayer believes that none of these categories of items is subject to use tax. The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

The sales tax is imposed by IC § 6-2.5-2-1, which states:

(a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.

(b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

The use tax is imposed under IC § 6-2.5-3-2(a), which states:

(a) An excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction.

Also, [45 IAC 2.2-3-4](#) provides:

Tangible personal property, purchased in Indiana, or elsewhere in a retail transaction, and stored, used, or otherwise consumed in Indiana is subject to Indiana use tax for such property, unless the Indiana state gross retail tax has been collected at the point of purchase.

Therefore, when tangible personal property is acquired in a retail transaction and is stored, used, or consumed in Indiana, Indiana use tax is due if sales tax has not been paid at the point of purchase. In this case, the Department determined that Taxpayer had acquired tangible personal property in retail transactions and used that property, either directly or indirectly by giving the property to its customers, in Indiana without paying sales tax at the point of purchase. The Department therefore issued proposed assessments for use tax, as provided by [45 IAC 2.2-3-4](#).

The first category protested concerns labor charges listed on one invoice. Taxpayer protests that only the cost of the parts listed on the invoice should be subject to use tax. The relevant statute is IC § 6-2.5-1-1, which states:

(a) Except as provided in subsection (b), "unitary transaction" includes all items of personal property and services which are furnished under a single order or agreement and for which a total combined charge or price is calculated.

(b) "Unitary transaction" as it applies to the furnishing of public utility commodities or services means the public utility commodities and services which are invoiced in a single bill or statement for payment by the consumer.

Also, [45 IAC 2.2-1-1](#)(a) states:

Unitary Transaction. For purposes of the state gross retail tax and use tax, such taxes shall apply and be computed in respect to each retail unitary transaction. A unitary transaction shall include all items of property and/or services for which a total combined charge or selling price is computed for payment irrespective of the fact that services which would not otherwise be taxable are included in the charge or selling price.

The Department considered the protested purchase to be a unitary transaction and that the entire amount of the invoice should be subject to use tax. As part of the protest process, Taxpayer was able to provide additional documentation which established that the invoice had separately stated amounts charged for materials and separately stated amounts for labor. There was not a total combined charge for all items and/or services; therefore this was not a unitary transaction. Taxpayer is correct that only the charges for materials are subject to use tax.

The second category protested by Taxpayer involves gift baskets it purchased as promotional items for its customers. The Department reviewed the available documentation and determined that Taxpayer had purchased tangible personal property and used it in Indiana without paying sales tax on those purchases. As part of the protest process, Taxpayer was able to provide additional documentation which established that all but one of the gift baskets were ordered from a third-party supplier and delivered from that supplier to customers outside of Indiana. Since all but one of the gift baskets were stored, used, or consumed outside Indiana, under IC § 6-2.5-3-2(a) those items are not subject to Indiana use tax and will be removed from the use tax calculations.

The third category protested by Taxpayer regards the purchase of a drill bit sharpener and parts for the drill bit sharpener. Taxpayer protests that the drill bits are essential to its manufacturing process. Taxpayer provided documentation regarding the necessity of drilling many holes in its product in the manufacturing process and the necessity of frequent sharpening of the drill bits for optimum performance and efficiency. The relevant statute is IC § 6-2.5-5-3, which states:

(a) For purposes of this section:

(1) the retreading of tires shall be treated as the processing of tangible personal property; and

(2) commercial printing shall be treated as the production and manufacture of tangible personal property.

(b) Except as provided in subsection (c), transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

(c) The exemption provided in subsection (b) does not apply to transactions involving distribution equipment or transmission equipment acquired by a public utility engaged in generating electricity.

(Emphasis added).

As provided under IC § 6-2.5-5-3(b), items must meet the "double direct" test in order to qualify for exemption. The Indiana Tax Court has addressed the question of what constitutes a manufacturing operation. In *General Motors Corp. v. Indiana Dep't of State Revenue*, 578 N.E.2d 399, 401 (Ind. Tax Ct. 1991), the Court provided:

The double direct standard, expressed in the statutory language emphasized above, is the touchstone of the equipment exemption from sales/use tax. In *Indiana Department of State Revenue v. Cave Stone, Inc.* (1983), Ind., 457 N.E.2d 520, the seminal case interpreting the double direct standard, the Indiana Supreme Court recognized the essential and integral test to determine whether the double direct standard is met. The court held the transportation equipment at issue was both essential to transforming crude stone into a marketable product and integral to "the ongoing process of transformation." Id. at 524.

Additionally, the Indiana Tax Court explained in *North Cent. Industries, Inc. v. Indiana Dep't of State Revenue*, 790 N.E.2d 198, 200 (Ind. Tax Ct. 2003):

To qualify for the equipment exemption, North Central must show, in part, that it is engaged in the direct production or manufacture of other tangible personal property. See *Gen. Motors Corp. v. Indiana Dep't of State Revenue*, 578 N.E. 2d 399, 401 (Ind. Tax Ct. 1991), *aff'd*. **If it satisfies this element, North Central must then show that the equipment for which it seeks an exemption is directly used in the production of the tangible personal property.** See Id.

Although "[t]here are innumerable ways to produce other tangible personal property, [Indiana Code Section 6-2.5-5-3] cannot be expected to give a precise answer to each factual situation that arises." *Rotation Prod.*, 690 N.E.2d at 798. **Nevertheless, the Department's rules make clear that production must entail a "substantial" change or transformation that "places tangible personal property in a form, composition, or character different from that in which it was acquired."** IND. ADMIN. CODE tit. 45, r. 2.2-5-8(k) (2001). Moreover, production must increase the number of "scarce economic goods," i.e., it must create a new, marketable product. *Harlan Sprague Dawley, Inc. v. Indiana Dep't of State Revenue*, 605 N.E.2d 1222, 1226 (Ind. Tax Ct.1992) (quoting *Borden Co. v. Borella*, 325 U.S. 679, 65 S.Ct. 1223, 89 L.Ed.

1865 (1945)).

**(Emphasis added).**

Therefore, equipment directly used in the direct production of Taxpayer's product is eligible for the manufacturing exemption.

In this case, the drill bit sharpener is not directly used in the direct production of Taxpayer's product. The drill bits themselves clearly are directly used in the direct production process and qualify for the exemption, but the sharpener is one step removed from the production process. Therefore, the sharpener itself does not pass the "double direct test" required by IC § 6-2.5-5-3(b), and the Department's determination that the purchase of the sharpener and related parts are subject to use tax was correct.

In conclusion, Taxpayer is sustained on the protest of labor charges listed on the invoice under protest. This was not a unitary transaction and only the materials were subject to use tax. Taxpayer is sustained on all but one purchase of gift baskets. The one gift basket which was shipped to an Indiana customer is still subject to use tax. Taxpayer is denied on the purchase of the drill sharpener and related parts. The sharpener does not pass the double direct test. The Department will conduct a supplemental audit and will issue reduced assessments based on the findings listed above.

#### **FINDING**

Taxpayer is sustained in part and denied in part, as described above.

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